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IN THE

SUPREME COURT OF THE UNITED STATES

No. 73-325

WAYNE E. BROWN and MARY RUTH BROWN,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Sixth Circuit

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PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals
For the Sixth Circuit

Petitioners, Wayne E. Brown and Mary Ruth Brown, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit, entered in the above-entitled case on April 30, 1973.

CITATIONS TO OPINIONS BELOW

The Findings of Fact, Opinion and Conclusions of Law of the United States District Court for the Southern District of Ohio, Eastern Division, are reported at 345 F. Supp. 241, 30 A.F.T.R. 2d 72-5682 (6/8/72) and reprinted in the appendix hereto. The order affirming the judgment of the District Court and further order denying a motion for rehearing are reprinted in the appendix hereto.

JURISDICTION

The judgment of the United States Court of Appeals for the Sixth Circuit was entered on April 30, 1973. The order denying a rehearing was entered on June 2, 1973. Jurisdiction of this Court is invoked under 28 U.S.C. Section 1254 (1). On application, the time within which to file this petition was extended to August 28, 1973.

QUESTION PRESENTED

Whether the Sixth Circuit erred in holding that the proceeds from a distribution in redemption of preferred stock by a publicly held corporation is essentially equivalent to a dividend rather than an exchange distribution where the redeeming shareholder at the time of redemption had voting control of the redeeming corporation, although only a minority interest in the capital structure of the corporation as a whole, the preferred stock was not held in proportion to common stockholdings, the redemption was not pro rata, and there was no plan covering a period of years for the distribution of dividends through the redemption process.

STATUTES INVOLVED

Title 26 United States Code

Internal Revenue Code of 1939

Sec. 115. (f) Stock Dividends—

(1) General Rule—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) Election of Shareholders as to Medium of Payment.—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)) then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

(g) Redemption of Stock—

(1) In General.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * *

Internal Revenue Code of 1954

Sec. 301. Distributions of Property.

(a) In General.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount Distributed.–

(1) General rule.–For purposes of this section, the amount of any distribution shall be–

(A) Noncorporate distributees. – If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

* * *

(c) Amount Taxable–In the case of a distribution to which subsection (a) applies–

(1) Amount constituting dividend.–That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * *

(3) Amount in excess of basis.–

(A) In general.–Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

* * *

(d) Basis.–The basis of property received in a distribution to which subsection (a) applies shall be–

(1) Noncorporate distributees.–If the shareholder is not a corporation, the fair market value of such property.

* * *

Sec. 302. Distributions in Redemption of Stock

(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317 (b), and if paragraph (1), (2), (3), or (4) or subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions treated as exchanges.—

(1) Redemptions not equivalent to Dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially Disproportionate Redemption of Stock.—

(A) In General.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears

to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of Redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of Shareholder's Interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

* * *

(5) Application of paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account.

* * *

(d) Redemptions treated as Distributions of Property—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of

section 317 (b), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * *

Sec. 305. (Ed. Note: This section was subsequently amended by the Tax Reform Act of 1969)

(a) General rule. Except as provided in subsection (b) gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock.

(b) Distributions in lieu of money. Subsection (a) shall not apply to a distribution by a corporation of its stock (or rights to acquire its stock), and the distribution shall be treated as a distribution of property to which section 301 applies—

* * *

(2) If the distribution is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either—

(A) In its stock (or in rights to acquire its stock) or

(B) In property.

* * *

Sec. 316. Dividend Defined.

(a) General Rule—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * *

Sec. 317. Other Definitions

(a) Property.—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) Redemption of Stock.—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

STATEMENT OF THE CASE

Petitioners are husband and wife with residence in Columbus, Ohio. They filed their joint federal income tax return for the calendar year 1964 with the District Director of Internal Revenue, Cincinnati, Ohio. All references hereinafter in this petition to "petitioner" are to Wayne E. Brown.

Respondent, the United States of America, through its agency, the Commissioner of Internal Revenue, asserted a deficiency in income tax against petitioners for the calendar year 1964, which was duly paid. Petitioners timely filed a claim for refund of taxes erroneously and illegally paid on which the Commissioner failed to take action within the statutorily required period of six months, although he later disallowed it on July 24, 1968. Brown filed a timely complaint in the United States District Court for the Southern District of Ohio, Eastern Division, and a subsequent amended complaint claiming an overpayment of federal income taxes for the calendar year 1964. After trial, the District Court entered judgment for respondent, which was appealed by petitioners to the United States Court of Appeals for the Sixth Circuit where the District Court was affirmed and which judgment forms the basis for this petition.

The controversy in question involves the taxable characterization of the proceeds from a distribution in redemption of 200 shares of preferred stock of Big Bear Stores Company (hereinafter called Big Bear) from petitioner for $21,000.00, i.e., is it a capital transaction entitled to exchange treatment or a dividend distribution to be treated as ordinary income?

Since its incorporation in 1933 petitioner has been president of Big Bear in addition to being a director and minority stockholder. The corporation owns and operates a chain of supermarkets and discount stores in the midwest

Prior to June 20, 1950 petitioners and their daughter owned 932 shares of the 3500 outstanding common shares of the corporation, the balance being owned by one George J. Miller and family and unrelated to petitioners. The corporation up to this point in time had marketed various debentures and a preferred stock issue through the Ohio Company. Petitioners owned none of these securities.

On June 20, 1950 Big Bear was recapitalized and in connection therewith all outstanding preferred stock was redeemed. Further, each holder of a share of the 3500 shares of common stock received in exchange therefore 50 shares of Class A (nonvoting) and 50 shares of Class B (voting) common stock. There was also an authorization for 3500 shares of preferred stock with a par value of $100.00, dividends to be paid at the rate of 5% per annum and sinking fund or redemption provisions requiring redemption after the lapse of five years from date of issue of 100 shares a year at $105.00 per share or compliance with the sinking fund provisions.

Also, on June 20, 1950 the Board of Directors of Big Bear voted a dividend of a share of the preferred stock authorization for each unit of the 50 shares of new Class A and B common stock, noting that the corporation had more than double the surplus necessary to cover the stock dividend and that failure to pay greater dividends in the past had been the result of using earnings for expansion purposes. As a result of this action $350,000.00 was transferred from earned surplus to stated capital. Before the declaration of this preferred stock dividend the shareholders (the petitioner and Miller interests) had the option of taking a cash dividend in lieu of the stock.

After the declaration of the preferred stock dividend, petitioners held 932 shares of the preferred stock in direct proportion to their common stock holdings, the balance being similarly held by the Miller interests.

After this recapitalization The Ohio Company underwrote and marketed 17,500 shares of the Class A common stock of Big Bear. In conjunction with this offering The Ohio Company required that the preferred stock have provision for redemption and advertised its priorities and the terms of redemption in their prospectus.

Until 1957 the Miller interests had voting control and had a majority interest in all classes of stock of Big Bear.

In January 1957, due to severe friction between Miller as controlling stockholder and petitioner as operating manager of Big Bear, these two parties devised a plan whereby Miller would be divested of his voting stock, but at the same time retaining his controlling economic interest in the corporation. This required another recapitalization of the corporation and involved a three for one stock split with respect to the Class A and B common stock, an increased authorization for the Class A common stock, a new issue of preferred stock, which in fact was never issued and is not at issue in this case, and an issue called "prior preferred stock" which was a perpetuation of the second issue or 1950 issue of preferred stock.

In connection with this recapitalization the holders of the 1950 or second issue of preferred stock were given the option of having their stock redeemed for cash or exchanging their stock for the newly authorized issue of "prior preferred stock", which retained the same par value, dividend rights, redemption and sinking fund requirements and priorities as the exchanged stock. Some of the shareholders elected to have their stock redeemed. Petitioner exchanged his preferred shares on a share for share basis for "prior preferred stock".

After the exchanges for prior preferred and the redemptions the "prior preferred stock" was owned on February 28, 1957, as follows:

Shareholder	Shares
Allen & Company	567
G. J. Miller	1021
Mary Ruth Brown	49
Marilyn Ruth Brown	45
Wayne E. Brown	838
Various employees of Big Bear	570
	3090

As a result of the recapitalization, The Ohio Company undertook to underwrite and merchandise 425,000 shares of Class A common stock of Big Bear and once again, as in 1950, advertised in the prospectus the priorities and redemption requirements with respect to the preferred stock. The Class A common stock had voting rights in certain prescribed situations, as did the "prior preferred stock".

As of February 28, 1964, and immediately before the redemption of 200 shares of the "prior preferred stock" held by petitioner in Big Bear the various classes of stock outstanding and those held by petitioner were as follows:

	Class A	Class B	Prior Preferred
Wayne E. Brown	89,573	37,944	838
Mary Ruth Brown	12,736	13,385	49
Ownership by daughter & grandchildren	25,423	126,944	45
Total	127,741	178,273	932
Total Outstanding	1,093,337	179,522	2,740
Percentage of all outstanding stock owned by Wayne E. Brown and family	11.7	99.3	34.01

(Percentage of ownership of total class A and B common stock outstanding is 24.04%.)

Big Bear had a history of paying regular dividends on all classes of stock outstanding and complied with the redemption requirements of preferred stock as advertised to the public and prescribed by the Amended Articles of Incorporation.

In early 1964 in the course of their annual audit of Big Bear, the Certified Public Accounting firm representing the corporation brought to the attention of the Secretory of the corporation the fact that the corporation was in arrears in its redemption commitments. The holders of the shares of the "prior preferred stock" were familiar with the fact that the corporation would redeem their stock as the corporate resources allowed and in accord with the sinking fund provisions. Generally, shares were voluntarily turned in for redemption in sufficient quantities to satisfy the sinking fund provisions. In this instance neither the Miller interests nor other holders of the "prior preferred stock" had voluntarily submitted their stock for redemption, so the corporate CPA and the Secretary brought the arrearage to the attention of petitioner. The corporation had previous to this time never been forced to take action through the Board of Directors to require stock to be redeemed; therefore, in this situation Brown agreed to have 200 shares of his "prior preferred stock" redeemed in order to comply with the sinking fund and redemption requirements of the corporation and also to meet the representations made by the corporation through The Ohio Company in the prospectus marketing the Class A common stock. This stock is now sold through the American Stock Exchange. The prior preferred stock of Brown was the closest at hand at the time to meet redemption requirements.

On February 29, 1964 Big Bear redeemed 200 shares of the "prior preferred stock" owned by petitioner. There was no economic or tax avoidance motive for the redemp-

tion, and these were the first and only shares of petitioner's "prior preferred stock" redeemed.

The joint return of petitioners for 1964 reported the $21,000.00 proceeds from the redemption at capital gains rates, after allowance for basis. The Commissioner determined the distribution was taxable as ordinary income.

REASONS FOR GRANTING THE WRIT

The implications of the decision in the case at bar if implemented would have a profound tax impact on stockholder corporate relationships in the situations where stock, both preferred and common, is redeemed from a shareholder, whether holding a majority or minority interest, and potentially even in situations involving arms-length sales of redeemable stock to unrelated third parties. The magnitude of the problem, although not measurable by the writers, must be substantial on a national scale. Specifically, the errors and reasons for requesting a writ are as follows:

(1) The decision of the Sixth Circuit is in irreconcilable conflict with other judicial circuits and the U. S. Tax Court.

(2) The Sixth Circuit grossly misinterprets and is in conflict with the holding and mandate of this Court in *U. S.* v. *Davis,* 397 U.S. 301, rev'g 408 F. 2d 1139 (1970).

(3) The Sixth Circuit in affirming the District Court assumes a plan of redemption calculated to result in dividend distributions which is not supported by the facts and based upon an erroneous statutory construction.

(4) Ohio law clearly required the redemption and any such transaction used as a guise for a dividend distribution would have been contrary to law subjecting petitioner to possible criminal and civil penalties.

STATUTORY CONSIDERATIONS

A stock redemption by a corporation will receive exchange treatment "if the redemption is not essentially equivalent to a dividend" as provided in section 302 (b) (1), Internal Revenue Code of 1954 (Title 26).[1] In this case this is the operative language of this section; however, it invokes the application and interrelation of other statutes.

Stock shall be treated as redeemed if the corporation acquires its stock from a shareholder in exchange for property, section 317 (b).

If there is such a redemption it shall be treated as a distribution in payment of such stock under section 302 (a), providing that one of four paragraphs under section 302 (b) applies. As indicated, the first of these paragraphs, section 302 (b) (1), grants exchange treatment in case the redemption is "not essentially equivalent to a dividend," and is the provision with which we are primarily concerned.

It is specifically pointed out that a qualification as a redemption under the requirements of this paragraph, section 302 (b) (1), will be made without regard to the fact that the transaction fails to qualify under paragraphs (2), (3) and (4) of section 302 (b). This clarifying statement is made at section 302 (b) (5).

At this point the statute almost goes full circle under section 302 (d) to state that stock shall be treated as redeemed by a corporation if it acquires its stock from a shareholder in exchange for property (this sub-section cites Section 317 (b) to this purpose), unless Section 301 applies.

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[1] All references hereinafter to a "section" is to the Internal Revenue Code of 1954 (Title 26 U.S.C.) unless otherwise indicated.

The statute then completes the circle by providing, section 301 (c) (3) (A), that if the distribution is not a dividend, the distribution shall be treated as gain from a sale or exchange to the extent that it exceeds the adjusted basis of the stock. If the provisions thus outlined do not apply, then the distribution will come within the provisions of Section 301 and be taxed as ordinary income.

I

Judicial Conflict

The foregoing illustrates that the statutory law, although relevant, is ambivalent. It provides little assistance in answering the rudimentary question of when a redemption is to be accorded exchange treatment and when the proceeds from such a redemption should be considered "essentially equivalent to a dividend." This task has been basically assumed by the judiciary. The concept of dividend equivalency in certain redemption situations has been a part of the Internal Revenue Code since 1921 and apparently was motivated in part by the decision of this Court in *Eisner* v. *Macomber*, 252 U.S. 189 (1920).

The criteria or tests evolved by the courts basically followed two courses in resolving the question of dividend equivalency in redemption cases. One line of cases followed what has come to be known as the "net effect" test which is well exemplified in its ramifications and complexities by the decision in *Himmel* v. *Commissioner*, 338 F. 2d 815 (2nd Cir. 1964). That Court recognized that it is possible for a transaction to resemble, exactly or substantially, either a divident or a sale and that the hallmarks of a dividend are a pro rata distribution of earnings and profits.

The second line of cases adopted by other circuits, including the Sixth and the Tax Court, took a more sub-

jective approach and considered "business purpose" in resolving the question of dividend equivalence. Thus, consideration was variously given to the reason for the redemption, whether corporate or shareholder, and the origin and purpose for which the redeemed stock was issued in allowing exchange treatment despite a pro rata distribution. An example of this line of cases is the decision of the Sixth Circuit in *U. S.* v. *Davis*, 408 F. 2d 1139, rev'd 397 U.S. 301 (1970). This Court in its reversal of the Sixth Circuit in *Davis* adopted the net effect test and thus eliminated a major source of conflict existing between the various courts.

Until the decision in the case at bar, in situations involving preferred stock redemptions the only judicially recognized method of testing dividend equivalency under the "net effect" test has been by what is called the "hypothetical" or "comparative" dividend test under which a court hypothesizes the declaration of a dividend, instead of the redemption of stock, in the same amount as the redemption and determines, from the standpoint of each stockholder-taxpayer, if the results from the hypothetical dividend and the actual redemptions are essentially the same. *Estate of Antrim* v. *Commissioner*, 395 F. 2d 430 (4th Cir. 1968), *Himmell* v. *Commissioner*, supra, *Northrup* v. *U. S.*, 240 F. 2d 304 (2nd Cir. 1957), *Ballenger* v. *U. S.*, 301 F. 2d 192 (4th Cir. 1962).

Applying this standard to the instant case the following result obtains: Had the $21,000.00 distribution from the redemption of the 200 preferred shares been a dividend declaration on common stock petitioner would have received only 24.04 percent of the proceeds or $5,048.40, a disparity which does little to suggest dividend equivalency.[2]

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[2] Actually, in the corporate fiscal year ending February 29, 1964, 30 additional shares of the preferred stock were redeemed from an un-

It has been suggested that as an alternative and more meaningful test that the dividend should be hypothesized "as if" all outstanding preferred stock had been redeemed. Although this approach would appear to be contrary to this Court's holding in *U. S.* v. *Davis,* supra (discussion infra), the result in the instant case would be as follows: Prior to the February 29, 1964 redemption of his 200 shares petitioner owned 932 out of 2710 outstanding or 34.39 percent. Thus, had there been a redemption of all outstanding preferred stock petitioner would have received 34.39 percent of the distribution as opposed to 24.04 percent he would have received under a dividend declaration. Again, such a disparity does little to indicate dividend equivalence. New York Institute on Federal Taxation, 28th Edition, 1970, pp. 744-45.

Aside from a mathematically computable percentage change in preferred stock ownership, a preferred stock redemption can and in the instant case does affect the following substantial rights: (1) rights to dividends, current and cumulative, (2) priority on liquidation, and (3) voting rights under certain designated circumstances. To the extent that these substantive rights are lost by petitioner as a redeeming shareholder they are essentially gained by the common shareholder. In other words, 24.04 percent of the relinquished rights would accrue to petitioner as a common shareholder and the balance, or 75.96 percent to the other common shareholders. By any criteria, this represents a meaningful reduction in his interest in the corporation.

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related taxpayer holding no common stock. If, as suggested in *Estate of Antrim* v. *Commissioner,* supra, the entire 230 share redemption should be considered in applying the hypothetical dividend test petitioner would have received 24.04 percent of $24,150.00 or $5,805.66.

As is apparent, any redemption of preferred stock cannot effect any change in the proportionate interests of the common stockholders. The preferred redemption may increase the equity interest represented by the common shares or accrue to them greater voting, dividend and liquidation rights, but it cannot change the percentage ownership represented by the shares. Further, to focus on a reduction in preferred ownership would seem to be totally irrelevant in analyzing the question of dividend equivalence. "Whether the preferred ownership declines by one percent or one hundred percent should not be the test of dividend equivalence. Rather, dividend equivalence should be determined by a comparison of the proceeds actually received in the preferred stock redemption with what the preferred shareholder would have received had an amount equal to the total preferred redemption proceeds been distributed as a dividend on common stock." New York University Institute on Federal Taxation, 28th Edition, p. 744.

A recent opinion of the Tax Court, reviewed by the court, considered the meeting of the hypothetical dividend test of *Himmel* v. *Commissioner*, supra, a condition precedent in applying the "net effect" test enunciated by this Court in *Davis* v. *U.S.*, supra. *Stanley F. Grabowski Tr.*, 58 T.C. No. 66 (1972). The Tax Court observed that where the redemption distribution exceeds an amount that would have been received under a dividend declaration, is non pro rata, and results in a meaningful reduction in the proportionate interest in the corporation (rather than an increase) that exchange treatment is strongly suggested. All of these pertinent factors recommending exchange treatment are present in the case at bar.

The District Court expressly rejects the hypothetical dividend criteria of *Himmel* v. *Commissioner*, supra, in resolving the question of dividend equivalence under the

"net effect" test as approved by this Court in *U. S.* v. *Davis,* supra. The Sixth Circuit, in rather summarily affirming the District Court, comments on petitioner's ownership of 99.3 percent of the Class B voting stock (discussion infra) and notes that the District Judge properly employed the "net effect" test of *U. S.* v. *Davis,* supra. It is suggested that no fair reading of the written opinion of this Court in *Davis* supports, either explicitly or implicity, a conclusion that the hypothetical dividend test is inapplicable in testing dividend equivalence, rather it supports its application, or the District Court's interpretation of that opinion in adopting the "net effect" test.

II

The Davis Case

This Court in *U. S.* v. *Davis,* supra, prefaces its analysis and sets the perimeter for its decision as follows: "We granted certiorari, 396 U.S. 815 (1969), in order to resolve this recurring tax question involving stock redemptions by closely held corporations." Reduced to its most basic terms, the Court holds that distributions in redemption of shares of solely owned corporations and pro rata redemptions in closely held corporations are always essentially equivalent to a dividend. In the course of reaching this conclusion the Court quite logically held as a corollary in rejecting the "business purpose" test that the origin or reason for the issuance or acquisition of the preferred stock or the reasons for redemption are irrelevant. Such considerations would be irrelevant under a strict construction of the "net effect" test. Of course, Big Bear isn't a close corporation, but a publicly held corporation whose nonvoting common stock is actively traded on the American Stock Exchange. Despite this difference, the basic principle enunciated should apply.

Petitioner's redeemed stock originated as a stock dividend. Under section 306 (a) and (c) of the Internal Revenue Code of 1954 redemption of such stock would be taxable as ordinary income but for the fact that section 306 (h) specifically provides that such section shall not apply to stock issued before June 22, 1954. Existing law under the Internal Revenue Code of 1939 applies with respect to dividend treatment on redemption, which law did not disqualify a redemption from a capital treatment based on the origin of the redeemed stock. Prior law as interpreted through *Davis* sets the applicable standard for determining dividend equivalence.

A key to the flaw in the reasoning of the District Court in interpreting section 302 in the light of *Davis* is to be found in footnote 4 to its opinion. (page 36, infra) Section 302 (b) (2), one of the safe harbor provisions, guarantees capital treatment on redemption if the redemption is substantially disproportionate (combined voting power of all classes of stock of the shareholder below fifty percent after redemption with reduction in the percentage of voting stock retained). The District Court states that *Davis* has made compliance with this safe harbor provision the controlling factor in determining dividend equivalency under section 302 (b) (1) despite the fact that, (1) this Court in its opinion in *Davis* did not in any manner, explicitly or implicitly, even allude to this as a factor to be considered, and (2) section 302 (b) (5) specifically provides that the failure to meet the safe harbor requirements of section 302 (b) (2), (3) and (4) shall not be taken into account in determining dividend equivalence under section 302 (b) (1). The underpinnings to the District Court's analysis collapses when it is realized that the impact of its decision is to hold that any redemption of preferred stock from a stockholder holding voting stock results in

a dividend equivalence. As pointed out earlier, a preferred redemption cannot alter the percentage holdings of voting common stock. It is suggested that neither Congress nor this Court intended the bizarre result of denying exchange treatment on the redemption of preferred stock from common shareholders in all circumstances.

Although the Sixth Circuit notes the majority percentage of voting stock held by petitioner, any reliance on this factor as a basis for affirming the District Court would appear to be theoretically defective. The statute at no place refers to voting control but speaks to voting power. Section 302 (b) (2) (B). All classes of Big Bear's stock had voting power. Both the Class A common and the preferred stock had voting rights in prescribed situations. That the condition of voting control is irrelevant is further reinforced by the fact that in determining whether a distribution in redemption is substantially disproportionate the ownership of nonvoting common stock is to be calculated in the computation. Section 302 (b) (2) (C). Petitioner owned only 24.04 percent of the two classes of common stock.

Both the Sixth Circuit and the District Court grasp this Court's language in *Davis* requiring a "meaningful reduction" of a shareholder's proportionate interest in the corporation to qualify for exchange treatment in support of their decisions. This concept in the context it is expressed seems eminently reasonable. It was formulated out of a judicial history wrestling with the antinome presented by the "business motivation" and "net effect" approaches to dividend equivalency. See footnote 2 to the *Davis* opinion. In this struggle dividend equivalence was occasionally found when the distribution was not strictly pro rata; however, in these situations a plan contemplating dividend distributions through the redemption process could fairly

be inferred from the facts coupled with a minimal variance in the shareholder's proportionate interest. Actually, as argued earlier, the percentage reduction in preferred stock ownership is irrelevant to dividend equivalency. In short, although the principle expressed by this Court is sound given the approach taken, i.e. pro rata distributions resulting from preferred stock redemptions, the application to the redemption in this case is out of context.

To those who would complaint of the equity of a situation allowing a taxpayer to realize capital gain on the redemption of stock received as a dividend, one answer is to point out that this is the law pre 1954 and Congress remedied this in the Internal Revenue Code of 1954. Section 306. However, another aspect of the situation should be explored. If a shareholder receives stock as a dividend, but had the election to receive money in lieu thereof, then such amount is taxable as ordinary income as a dividend and any subsequent pro rata redemption would result in a second taxation at ordinary income rates, all arising out of the same stock. Section 115 (f) (2), Internal Revenue Code of 1939 and Section 305 (b) (2), Internal Revenue Code of 1954. This is not to endorse the equity of the above-described tax consequences, but the results have the virtue of philosophical consistency and clearly follow the mandate of *Davis*. As Justice Marshall so aptly expressed it there, ". . . . the difference between form and substance in the tax law is largely problematical, and taxpayer's complaints have little to do with whether a business purpose is relevant under 302 (b) (1)." Equity and consistency require the same treatment should be accorded respondent.

III

The Redemption Plan

The preferred stock issue in question was authorized in 1950 and perpetuated in the 1957 recapitalization of Big Bear. The Amended Articles of Incorporation provided (after the lapse of five years) for the redemption of the shares at the rate of at least 100 shares per year or compliance with sinking fund provisions providing for such retirement. Thus, the authorized issue of 3500 shares was to be redeemed over a forty year period and this fact was properly divulged to the public in the prospectus marketing the 1950 and 1957 offerings of Class A common stock. In 1964 200 shares were redeemed from petitioner in compliance with the redemption requirements and for reasons which are not relevant since the decision by this Court in *Davis*. These are the only shares ever redeemed from petitioner.

The District Court in this case finds a series of redemptions whose economic effect is a dividend distribution. In arriving at this conclusion the Court uses as support the opinion in *Blount* v. *Commissioner*, 425 F. 2d 921 (2nd Cir. 1969) which in turn, in finding dividend equivalence on the redemption of common stock under a retirement plan, relied on subparagraph (D) of section 302 (b) (2), relating to a series of redemptions, in analyzing the transaction under section 302 (b) (1). Reliance by the court on *Blount* seems completely misplaced. The redemption involved common stock in a close corporation which was to be redeemed pursuant to a specific plan providing for the retirement of the older stockholders. The corporation had paid no dividends for twenty years. Although the redemption plan was not strictly pro rata (one shareholder was allowed redemption of a greater amount than his pro

rata interest), the Court found dividend equivalence since redemption from the shareholder not holding pro rata actually would result in increasing the taxpayer's proportionate interest in the corporation. Subparagraph (D) to section 302 (b) (2) makes inapplicable this safe harbor provision (distribution or redemption substantially disproportionate with respect to the shareholder) where the purpose of a plan for a series of redemptions is, when considered in the aggregate, not substantially disproportionate. The invoking of section 302 (b) (2) (D) as an instrument in measuring dividend equivalency under section 302 (b) (1) in a preferred stock redemption is clearly in error since by the terms of section 302 (b) (2) the section only purports to apply to common stock, aside from the fact that section 302 (b) (5) would make such a consideration inapplicable.

The decision in *Davis* would appear to preclude a consideration of a series of transactions extending beyond a taxable year by its application of the "net effect" test to section 302 (b) (1). There is, of course, authority for viewing a transaction in steps that span more than one taxable year as one integrated transaction and viewing the tax consequences accordingly. However, this Court has been hesitant in applying the "step transaction" doctrine with the consequent disregard for the integrity of the tax year. See *Commissioner* v. *Gordon*, 391 U.S. 83 (1968), The Journal of Taxation, July 1968, p. 2. This hesitancy is also reflected in the regulations to section 302, "All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under section 301 if the corporation has only one class of stock outstanding . . . . The redemption of all of one class of stock . . . . either at one time or in a series of redemptions generally will be considered as a

distribution under section 301 *if all classes of stock outstanding at the time of the redemption are held in the same proportion.*" Regulation § 1.302-2 (b). (Emphasis added) Even in the pre *Davis* decisions where the courts, as in *Blount,* have transcended the taxable year to find dividend equivalence there has always been a specific plan, or one readily inferrable, for the purpose of making pro rata dividend distributions through the redemption process and the plan was reasonably susceptible of execution. Compare *James F. Boyle,* 14 T.C. 1382 (1950), aff'd 187 F. 2d 557 (1951), cert. den. 342 U.S. 817. Even the example given in the legislative history relating to subparagraph (D) of section 302 (b) (2) suggests the need for such specifics. Senate Committee Report (83d Cong., 2d Sess. S. Rep. No. 1622 (1954) 233).

The preferred stock issue involved in this case contemplates redemption over a span of forty years. Between 1950 and 1964 (the redemption year) petitioner's proportionate interest in Big Bear varied as a result of preferred stock redemptions, public sales of Class A common stock and the 1957 recapitalization. It is totally unrealistic to hypothesize potential redemptions of preferred stock over a forty year period with numerous possible variables and telescope the transaction into one tax year based on speculative assumptions. To have dividend equivalence from such an hypothesized series of redemptions requires, at least, the following assumptions: (1) Petitioner's continuing pro rata interest in Big Bear, (2) No sale of common or preferred stock, (3) No further issuance and sale to the public of common stock by Big Bear as authorized, (4) No subsequent recapitalization, (5) No termination of petitioner's interest in Big Bear under section 302 (b) (3) or termination of the preferred stock interest alone, (6) Big Bear does not liquidate or become bankrupt, and (7) petitioner survives to have his stock redeemed.

It is submitted that there is no judicial or legislative support for hypothesizing a series of redemptions in order to find dividend equivalence based on the facts in the case at bar.

IV

Ohio Law

Big Bear is an Ohio corporation with its principal place of business in Columbus, Ohio.

Petitioner's fiduciary obligation as officer and director of Big Bear to all classes of shareholders is clear. He may not derive personal profit. He may not favor any class of shareholders with respect to dividend policy. He may not favor himself in any redemption policy. See 12 Ohio Jurisprudence 2d, Corporations, Sections 496, 497; 13 Ohio Jurisprudence 2d, Corporations, Section 665; and *Byrum* v. *United States*, — U.S. —, 30 A.F.T.R. 2d § 147,675 (6/26/72).

The Class A common stock of Big Bear was sold to the public with the representation that the "prior preferred" stock would be redeemed. There is neither evidence nor a contention in this case that petitioner favored himself in the redemption in question. In fact, as an officer and director he had the ultimate obligation to redeem his shares at some point in time over forty years. If this redemption represents a dividend to petitioner he is probably subject to criminal penalties under Ohio law. Sections 1707.44 and 7207.99, Ohio Revised Code.

Clearly, the "net effect" of the redemption was not a dividend distribution.

The subsidiary question as to the basis of the redeemed stock under section 115 (f) (2), Internal Revenue Code of 1939 or section 305 (b) (2) of the 1954 Code was not

resolved by the courts below, it not being necessary to their decisions.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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APPENDIX

IN THE
DISTRICT COURT OF THE UNITED STATES
FOR THE SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

Civil No. 68-228

WAYNE E. BROWN and MARY RUTH BROWN,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

FINDINGS OF FACT, OPINION AND CONCLUSIONS OF LAW

(Filed June 8, 1972)

I

FINDINGS OF FACT

(1) Plaintiffs Wayne E. Brown and Mary Ruth Brown, husband and wife, filed a joint tax return for the year 1964. A deficiency in the sum of $10,216.43 was assessed against them for the year 1964 by the Internal Revenue Service and the deficiency was subsequently paid. A timely claim for refund of the deficiency assessed and paid was filed by the plaintiffs and subsequently disallowed by

the Internal Revenue Service. On July 12, 1968, the complaint in the above entitled matter was filed in the United States District Court for the Southern District of Ohio. All procedural steps necessary for a full determination of this matter on its merits have been taken and it is before the United States District Court for adjudication.

(2) Big Bear Stores Company is an Ohio corporation, incorporated in November, 1933. Prior to June of 1950, the common stock in said corporation was owned either legally or beneficially by the Miller family or the Brown family, 932 shares of 3500 outstanding being owned either by Wayne E. Brown, Mary Ruth Brown, or their daughter Marilyn.[1] At such point in time a previous issue of 2,000 shares of first preferred stock, par value of $100 per share, dated 1943, had been retired in full.

(3) On June 20, 1950, articles of incorporation of the Big Bear Stores Company were amended to provide for 3500 shares of $100 par value second issue preferred stock. This was intended to be and was in fact a stock dividend since it was issued pro rata without additional consideration on all shares of common stock outstanding.[2] On June 20, 1950, the Brown family acquired 932 shares of 3500 outstanding. On the same date, additional stock was issued at the rate of 50 shares of Class A common and 50 shares of Class B common, in exchange for each share of common stock then owned. The only difference between Class A

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[1] Although Marilyn Brown Kellough is not a party to this action, it is recognized that her shares must be deemed beneficially owned by plaintiffs, under the attribution rules of section 318 of the Internal Revenue Code, made applicable to section 302. See, e.g., *Levin* v. *Commissioner*, 385 F.2d 521 (2d Cir. 1967).

[2] In addition, $350,000.00 was transferred from earned surplus to stated capital, based upon 3500 shares of preferred a par value of $100 per share.

and Class B common stock was that Class B had voting rights of one vote per share, while Class A had none.

(4) In 1957, the Brown interests gained voting control of Big Bear Stores Company. At this time, the second issue preferred stock issued in 1950 was redeemed and a new issue of "prior preferred" stock was authorized. 410 shares of the 1950 preferred stock had been redeemed between 1950 and 1957, 200 of such shares by the Miller interests in 1956 and 1957. Holders of the remaining 3090 shares of that stock in 1957 were granted the option either to redeem for cash or substitute the 1957 prior preferred stock on a share for share basis.

(5) Between 1957 and 1967,[3] 1066 more shares of the newly issued prior preferred stock were redeemed, by a number of individual public shareholders. On February 29, 1964, the corporation redeemed 200 shares of plaintiffs' prior preferred for $21,000.00. In that year only 230 shares in total were redeemed.

(6) As of February 28, 1964, immediately before corporate redemption of 200 shares of the Browns' stock, the percentage of shares held by the Brown family was as follows: Class A stock — 11.7%; Class B stock — 99.3%; Prior Preferred stock — 34.01%.

(7) Redemption of the Browns' preferred stock had no effect on either their percentage of voting control nor their proportionate ownership of common stock. Between February 28, 1964, the date of the 200 share redemption, and February 29, 1964, the following day, the Brown family's percentage of prior preferred dropped from 34.01%

[3] See Plaintiffs' Exhibit 3 of Exhibit B, attached to their complaint. This action was filed in 1968 and the corporate redemption figures for 1968 to the present date have not been filed with the Court.

to 29.2%. In 1950, before any stock was redeemed, the Brown family's proportionate ownership of the original second issue preferred was 26.63%. As of 1967, after 1066 of the prior preferred had been redeemed, their proportionate ownership of preferred had risen to 35.47%.

(8) The preferred stock issued in 1950 and the prior preferred stock reissued in 1957 were both subject to the same limitations: redemption was at the option of the Company at the rate of $105.00 per share. A sinking fund for redemption purposes was required, with an annual deposit from net earnings of a sum equal to the redemption value of 100 shares. Redemption of less than all the outstanding shares to be determined in a fashion selected by the corporate Board of Directors. Thus, the holders of preferred stock had no right to demand redemption and the company was under no obligation to redeem the shares, or any specific share, at any particular point in time.

(9) No sinking fund was ever established, as required by the 1950 and 1957 amended articles of incorporation. Instead, the corporation complied with these provisions by redeeming shares directly from stockholders at a rate of 100 per year until such issue was retired. Up until 1964, shares had been voluntarily turned in for redemption in sufficient quantities to satisfy the sinking fund provisions. The 1964 redemption of the stock transpired when a corporate accountant discovered that the company was 200 shares behind in its schedule and requested plaintiff Wayne Brown to make up this deficiency. Plaintiff agreed and these were the only shares he has ever redeemed.

(10) In 1964, when the plaintiff agreed to redemption of his stock, the corporation had an earned surplus in excess of Seven Million ($7,000,000.00) Dollars, sufficient to cover the distribution here in issue.

II

OPINION

This case concerns the redemption in 1964 of 200 shares of preferred stock owned by taxpayers in The Big Bear Stores Company. The sole question presented is whether this redemption was "essentially equivalent to a dividend," within the meaning of section 302 (b) (1) of the Internal Revenue Code of 1954[1] and therefore subject to taxation as ordinary income under related sections of the Code, or rather a payment in exchange for ownership of stock (i.e. a sale), entitled to more favorable capital gains taxation.

The legislative history and purposes of section 302 (b) (1) have been thoroughly analyzed by other courts, and it is not necessary to repeat that process here. It is sufficient to say that, as recently announced by the Supreme Court, the fundamental test in determining dividend equivalency under section 302 (b) (1) is whether the distributions have the "net effect" of a dividend; that is, whether "the effect is to transfer the propery from company to its shareholders without a change in the relative economic interests or rights of the stockholders." See, *United States* v. *Davis*, 397 U.S. 301, 313 (1970). See, generally, *Commissioner* v. *Estate of Bedford*, 325 U.S. 283 (1945). Where redemptions have resulted in a *meaningful reduction* of the

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[1] 302. **Distributions In Redemption of Stock**

(a) **General Rule.**—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) **Redemptions Treated as Exchanges.**—

(1) **Redemptions not equivalent to dividends.**—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

redeeming shareholder's proportionate interest in a corporation, or have effected a distribution of earnings and profits to him which is not reasonably pro-rated in relation to other shareholders' proportionate interests, they have been viewed as more resembling a sale than a dividend. See, *Himmel* v. *Commissioner,* 338 F.2d 815 (2d Cir. 1964); *Sorem* v. *Commissioner,* 334 F.2d 274 (10th Cir. 1964); *Ballenger* v. *United States,* 301 F.2d 192 (4th Cir. 1962); *Cobb* v. *Callan Court Co.,* 274 F.2d 532 (5th Cir. 1960); *Northrup* v. *United States,* 240 F.2d 304 (2d Cir. 1957).

Additional factors previously considered by courts, such as who initiates the redemptions and how significantly they contract corporate operations, see, generally, 1 Mertens § 9.100, at 214-215, if they have any continuing vitality at all, must be considered subordinate to the "net economic effect" test enunciated in *Davis, supra.* The business purpose or motive of the corporation in undertaking stock redemptions is expressly made irrelevant by that case.

In the case at bar, resolution of the dividend equivalency issue is made more difficult by the presence of two complicating factors: First, the redemptions in this case took place over an extended period of time and involved two separate issues of stock. Second, the capitalization structure of Big Bear Stores Company was multivariated and complex.

In a case of this sort, the threshold question is to decide which transactions are relevant. Most of the section 302 (b) (1) cases our research has uncovered have involved a single redemption, or at most two redemptions, in one or two consecutive tax years. In these cases, it is a simple matter, at least relatively, to compare the economic relationship of the taxpayer to the corporation before and

after his stock has been redeemed. In contrast, cases involving multiple redemptions, pursuant to a single plan and carried out over a number of years, have been relatively few. See, *In re Lukens' Estate*, 246 F.2d 403 (3d Cir. 1957); *Cobb* v. *Callan Court Co., supra; Northrup* v. *United States, supra; Blount* v. *Commissioner*, 425 F.2d 921 (2d Cir. 1969). In *Northrup*, the Second Circuit Court of Appeals focused without discussion upon three specific tax years in question even though the redemption plan adopted by the corporation remained in effect for twelve years, terminating only when the entire issue of preferred stock was retired. On the other hand, the Third Circuit in *Lukens' Estate* and the Fifth Circuit in *Cobb* looked over the entire course of redemption in making their determination of dividend equivalency.

No court, however, had expressly addressed itself to this question until Judge Friendly, for the Second Circuit, did so in *Blount* v. *Commissioner, supra*. Holding that the overall economic effect of a series of redemptions upon the taxpayer is the relevant inquiry, the Court stated as follows:

> In determining dividend equivalence here, the first step is to decide which transactions are relevant. Taxpayer contends that we should look only at the effect of Howard's redemptions during the years in question here. The Commissioner argues that we should view all the redemptions contemplated by the retirement agreement as part of a single plan, and base our determination on the effect of the entire series. We think the Commissioner's view is correct. It is specifically provided with respect to qualifying under § 302 (b) (2), see subparagraph (D),[4] and Congress could

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[4] Sections 302(b)(2) and 302(D), concededly not directly applicable to the present case, provide in part as follows:

> hardly have meant qualification under 302 (b) (1) to be easier in this regard. See Pacific Vegetable Oil Corp. v. C.I.R., 251 F.2d 682 (9 Cir. 1957), and, for cases where the principle of looking beyond the tax years in question was applied in favor of the taxpayer, Giles E. Bullock, 26 T.C. 276, 295 (1956), *aff'd* per curiam, Bullock v. Commissioner of Internal Revenue, 253 F.2d 715 (2 Cir. 1958); and Lukens' Estate v. C.I.R., 246 F.2d 403 (3 Cir. 1957). [footnote added] *Id.*, 425 F.2d at 924.

The *Blount* decision has the effect of impliedly overruling the contrary approach earlier adopted by the Second Circuit in *Northrup, supra.* In any event, this Court finds the reasoning in *Blount* persuasive and controlling in the present case.

The problems in determining dividend equivalency, while always difficult, are further exacerbated when, as

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302(a) **General Rule.**—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) **Redemptions Treated as Exchanges.**—

* * *

(2) **Substantially disproportionate redemption of stock.**—

(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

* * *

(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

Since the "substantially disproportionate distribution" criterion of § 302(b)(2) has been made a controlling factor in determining dividend equivalency under § 302(b)(1), see *United States* v. *Davis, supra*, logic dictates that the provisions of subsection D apply to 302(b)(1) cases as well.

in the present case, the capital structure of the redeeming corporation is diversified and various classes of stock are held in different proportions by different stockholders. See, generally, *Himmel* v. *Commissioner, supra.* As the *Himmel* case recognizes, ownership of stock involves various rights — the right to vote, to participate in earnings and surplus and to share in net assets on liquidation — not all of which accrue to the holders of limited stock. *Id.,* 338 F.2d at 817. Whereas dividends on common stock give rise to pro-rata distributions or earnings and profits, or, in the case of stock dividends, to proportional distributions of equity not affecting basic shareholder relationships, the effect of redeeming preferred stock will depend upon the exact preferences and limitations upon such stock and may cause different changes in a shareholder's total rights than redemption of common. In order to determine dividend equivalency, the Court in *Himmel* compared the precise effect upon a preferred shareholder of redemption of his preferred stock to the effect that a hypothetical dividend on common stock would have had upon his and other shareholders' rights. See also, *Commissioner* v. *Estate of Antrim,* 395 F.2d 430 (4th Cir. 1968); *Northrup* v. *United States, supra.* Plaintiffs in this case would have us adopt this approach. Discussion of the *Himmel* case appears below.

An application of the above stated principles to the facts of this case shows that over the period of years during which the Big Bear Stores' redemption plan was in effect, taxpayers surrendered *less* than their pro rata share of preferred shares, with the result that their ownership percentage of preferred actually increased rather than decreased. The number of shares owned by the Brown family and their relative percentage of the entire outstanding issue at various key points in time was as follows:

	6/20/50*	1/16/57**	2/29/64***	2/25/67****
Brown family	932 (26.63%)	932 (30.16%)	732 (29.16%)	732 (35.47%)
	3500	3090	2510	2024

* Institution of redemption plan for second issue preferred.

** Remaining unredeemed 3090 shares of second issue preferred retired; prior preferred issued on share for share basis; redemption plan continued.

*** 200 shares of Brown family stock redeemed.

**** Last date supplied to Court; total of 2024 shares not yet redeemed.

Even assuming *arguendo* that our inquiry were limited to the change in the Browns' proportionate ownership of preferred stock between the years 1957 and 1964, we could not conclude that the resultant 1% decrease in their ownership in these years constituted a "*meaningful* reduction" of their "proportionate interest in the corporation," as required by the Supreme Court in the *Davis* case. 397 U.S. at 313 (emphasis supplied). No case presenting similar facts that we have found has so concluded. See, *passim*, *Himmel* v. *Commissioner, supra,* at 818-819.

Viewing, as we must, the redemption plan in its entirety, we find that the taxpayers have not parted with anything which would justify capital gains treatment of the cash they received on redemption. See, *Levin* v. *Commissioner,* 385 F.2d 521, 527-8 (2d Cir. 1967). It has been observed that section 302 (b) (1) must be construed narrowly since "its major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." See, Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (2d ed.), 291. Courts have accordingly recognized that where a shareholder's proportionate ownership is actually increased as a result of a redemption plan, the outcome "is most unlike a sale," and capital gains

treatment is inappropriate. *Levin* v. *Commissioner, id.,* at 527; *Blount* v. *Commissioner, supra.* In such a series of transactions, as presented in the case at bar, the taxpayer gives up nothing in the way of corporate ownership and control, but nevertheless comes into possession of a sum of money, distributed to him out of the earnings of the corporation. This money is "essentially nothing but a dividend and is properly taxed as such." See, *Wiseman* v. *United States,* 371 F.2d 816, 818 (1st Cir. 1967); *Coyle* v. *United States,* 415 F.2d 488 (4th Cir. 1968).

We reach this result not without difficulty, for an application of the "hypothetical dividend" test enunciated in *Himmel, supra,* leads to a different conclusion. After corporate reorganization in 1957 and up to and including 1964, taxpayers' proportionate ownership of common stock, both Class A and Class B, approximated 55%. During these years, 580 preferred shares were redeemed, at a total par value of $58,000.00. Only 200 of plaintiffs' shares were redeemed, at a par value of $20,000.00. Thus, plaintiffs received only 34.5% of the redemption of preferred; whereas, had a dividend on common stock been distributed, they would have been entitled to a proportionate share of 55%.

There is no evidence that the Browns or any other stockholders were required to give up their shares for redemption in proportion to their relative interests in the corporation. What little evidence has been presented suggests that these redemptions were not intended to be made on a pro rata basis but rather were haphazard and voluntary on the part of shareholders.

Nevertheless, in analyzing the strict net economic effect of the transactions in the present case, we can only conclude that the redemption of taxpayer's preferred stock, no matter how fortuitous, did not meaningfully reduce their pro-

portionate interest in the corporation, and that therefore, under the rule set out by the Supreme Court in *United States* v. *Davis, supra,* the cash received for such stock cannot qualify for capital gains treatment. To the extent that *Himmel* v. *Commissioner, supra,* sets out different criteria for determining dividend equivalency, we do not think that it can be reconciled with the clear language of *Davis* and we decline to follow its holding.

III

CONCLUSIONS OF LAW

Accordingly, the Court holds that the cash received by plaintiffs in 1964 in exchange for redemption of their preferred stock in Big Bear Stores Co., Inc. was *not* "substantially equivalent to a dividend" within the meaning of Section 302 (b) (1) of the Internal Revenue Code of 1954, and hence was taxable as ordinary income to plaintiffs. The assessment and collection of Ten Thousand, Two Hundred Sixteen and 43/100 ($10,216.43) Dollars by the Internal Revenue Service by plaintiffs was therefore correct, and plaintiffs' claim for refund of taxes alleged to have been erroneously collected is hereby DENIED.

It is so ORDERED.

No. 72-2020

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

WAYNE E. BROWN and MARY RUTH BROWN,
Plaintiffs-Appellants,

vs.

UNITED STATES OF AMERICA,
Defendants-Appellees.

ORDER
(Filed April 30, 1973)

Before: EDWARDS and CELEBREZZE, Circuit Judges, and O'SULLIVAN, Senior Circuit Judge.

On receipt and consideration of the briefs and oral arguments in the above-styled case; and

Noting that appellants (taxpayers), owners of 99.3% of the voting stock of the Big Bear Stores Company, argue that the sum of $21,000 paid for redemption of 200 shares of preferred stock in 1964 (which stock had originally been received as a stock dividend in 1950) should be taxed on the basis of a capital gain; and

Further noting that the District Judge, properly employing the "net effect" test of *United States* v. *Davis*, 397 U.S. 301 (1970), held that "we can only conclude that the redemption of taxpayers' preferred stock, no matter how fortuitous, did not meaningfully reduce their proportionate interest in the corporation, and that therefore, . . . the cash received for such stock cannot qualify for capital gains treatment."

The judgment of the District Court is affirmed.

No. 72-2020

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

WAYNE E. BROWN and MARY RUTH BROWN,
Plaintiffs-Appellants,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee.

ORDER

(Filed June 21, 1973)

Before: EDWARDS and CELEBREZZE, Circuit Judge, and O'SULLIVAN, Senior Circuit Judge.

On consideration of plaintiffs' petition for rehearing and suggested rehearing in banc; and

No active judge of this court having moved for rehearing in banc, and the motion for rehearing having been referred to the panel of the court which heard the case; and

That panel noting that no issues were presented in the motion for rehearing which were not fully considered prior to the issuance of the order of the court,

Said motion for rehearing is hereby denied.

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In the Supreme Court of the United States

OCTOBER TERM, 1973

WAYNE E. BROWN AND MARY RUTH BROWN,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-325

WAYNE E. BROWN AND MARY RUTH BROWN,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

In 1950, petitioners received a tax-free dividend of preferred stock in Big Bear Stores Company ("Big Bear") on the basis of one share of preferred stock for each share of common stock held (Pet. App. 30). At that time, petitioners held 932 of the 3,500 shares of common stock outstanding and received 932 shares of the 3,500 shares of preferred stock issued as a stock dividend (Pet. App. 30). Thereafter, Big Bear's common stock was reclassified into nonvoting Class A and voting Class B stock (Pet. App. 30-31). In 1957, petitioners acquired 99.3 per cent control of the Class B voting stock (Pet. App. 31). During that year, Big Bear also created a new issue of prior preferred stock which replaced the 1950 issue of preferred stock on a share for share basis (Pet. App. 31).

The preferred stock was issued with a sinking fund provision that required an annual deposit from net earnings adequate to redeem 100 shares each year. Although the sinking fund was never formally established, the corporation complied with its requirements by redeeming shares directly from stockholders at the rate of 100 shares per year until the issue was retired (Pet. App. 32). In 1964, as part of the redemption plan, Big Bear redeemed 200 shares of petitioners' preferred stock for $21,000 (Pet. App. 31). At the time of the redemption the percentage of all shares held by petitioners in Big Bear was as follows: Class A stock—11.7 percent; Class B stock—99.3 percent; preferred stock 34.01 percent (Pet. App. 31).

The district court upheld the Commissioner's determination that the redemption of petitioners' preferred stock was "essentially equivalent to a dividend" within the meaning of Section 302(b)(1) of the Internal Revenue Code of 1954 so that the $21,000 they received was taxable as ordinary income and not as capital gain (Pet. App. 40).[1] In a brief order, the court of appeals affirmed (Pet. App. 41) and subsequently denied petitioners' petition for rehearing and suggestion of rehearing *en banc* (Pet. App. 42).

1. Contrary to petitioners' contention (Pet. 20-23), the decision below is not in conflict with *United States* v. *Davis*, 397 U.S. 301, but rather is in accord with that decision.

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[1] The italicized word "not" appearing in the Conclusions of Law as printed in the Appendix to the Petition (Pet. App. 40) was erroneously inserted before the words "substantially equivalent to a dividend" in the Conclusion of Law as originally filed by the district court. This error was subsequently corrected in the published opinion. See 345 F. Supp. 241.

Distributions to shareholders out of a corporation's earnings and profits are generally treated as taxable dividends under Sections 301 and 316 of the Internal Revenue Code of 1954. Similarly, distributions made by a corporation in redemption of its stock are treated as dividends unless the redemption qualifies under one of the four exceptions in Section 302(b).[2] The exception here at issue is Section 302(b)(1), which provides that a corporation's redemption of stock shall be treated as a distribution in part or full payment in exchange for the stock if the redemption is "not essentially equivalent to a dividend." If the redemption so qualifies, the difference between the amount received by the shareholder and his cost basis in the stock will be taxable as capital gain.

In testing for dividend equivalency under this provision, this Court, in *United States* v. *Davis, supra,* 397 U.S. at 310-311, stated that Congress intended Section 302(b)(1) to apply to only those redemptions which could be characterized as a sale of the stock by the shareholder to the corporation. If the surrender of stock by a shareholder in a redemption is a meaningless act carrying with it no substantial change in ownership rights, such a transaction could hardly be deemed to be a sale. Accordingly, the Court in *Davis* approved the strict net effect test which denies capital gains treatment under Section 302(b)(1) unless the redemption results in a meaningful reduction of the shareholder's proportionate ownership interest in the corporation.

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[2] That the law of Ohio, cited by petitioners (Pet. 27-28), might prohibit the use of a redemption as a guise for a dividend distribution does not prevent the taxation of the distribution in question as a dividend in accordance with the requirements of the Internal Revenue Code.

The redemption here is precisely the type of transaction that Section 302 and its predecessors[3] were designed to subject to dividend treatment. Indeed, the original antecedent of Section 302, adopted in 1921 after this Court's decision in *Eisner* v. *Macomber*, 252 U.S. 189, holding that pro rata stock dividends were not taxable, was specifically directed to imposing dividend taxation upon the redemption of stock that had been distributed as a tax-free stock dividend. See *United States* v. *Davis, supra*, 397 U.S. at 308. Viewing the overall economic effect of the stock dividend here and the subsequent redemptions of Big Bear preferred stock over the years during which its redemption plan was in effect, there was no meaningful change in the proportionate ownership and control of the corporation by reason of the redemption.

Indeed, during the relevant period, 1950-1967, petitioners' proportionate interest in the preferred stock actually increased from 26.63 percent to 35.47 percent.[4] Where a shareholder's proportionate interest

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[3]Section 201(d) of the Revenue Act of 1921, 42 Stat. 228; Section 201(g) of the Revenue Act of 1926, 44 Stat. 11; Section 115(g) of the Revenue Act of 1928, 45 Stat. 822. Section 115(g) was carried over in the 1939 Code.

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[4] The percentage of preferred stock owned by petitioners at various times was as follows (Pet. App. 38):

1. June 20, 1950 (when the redemption plan for the 1950 issue was instituted)—26.63 percent.

2. January 16, 1957 (when the remaining unredeemed 3,090 shares of the 1950 issue preferred were retired and the prior preferred stock issued)—30.16 percent.

3. February 29, 1964 (when petitioners' 200 shares of 1950 issue preferred were redeemed)—29.16 percent.

is increased as a result of the redemption plan, the outcome is "most unlike a sale" and capital gain treatment is inappropriate. *Levin* v. *Commissioner,* 385 F. 2d 521, 527-528 (C.A. 2); *Blount* v. *Commissioner,* 425 F. 2d 921, 925 (C.A. 2). Moreover, the preferred stock redemption had no effect on any of petitioners' common stockholdings. Their relative voting rights (99.3 percent) with respect to their common stockholdings remained the same after the redemption. Thus, taking into account the fact that there was no change in shareholder relationships, much less a meaningful one, both courts below correctly held, under the rule announced in *Davis,* that the $21,000 payment was taxable as a dividend.

Contrary to petitioners' contention (Pet. 24-26), the courts below properly looked to the overall economic effect of all the redemptions by Big Bear over the period 1950 to 1967. See, *e.g., Blount* v. *Commissioner, supra; In re Lukens' Estate,* 246 F. 2d 403 (C.A. 3); *Stein* v. *United States,* 62 F. Supp. 568 (Ct. Cl.). Cf. Section 302(b)(2)(D).[5] However, even if the redemption here is considered only during the taxable year at issue, 1964, the *Davis* standard for nondividend equivalency was not met. The one percent decrease in petitioners' proportionate interest in the preferred stock between January 16, 1957 (30.16 percent) and the date of the redemption (29.16 percent) was hardly a meaningful change.

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4. February 25, 1967 (the last date supplied to the district court as of which 2,024 shares of preferred stock were not yet redeemed)—35.47 percent.

[5] Nothing in *Commissioner* v. *Gordon,* 391 U.S. 83, relied upon by petitioners (Pet. 25), would prevent viewing the net effect of Big Bear's redemption plan as a whole.

2. Contrary to petitioners' contentions (Pet. 14, 16-20, 22-23), the decision below is not in conflict with that of any other circuit. Although both the Second Circuit in *Himmel* v. *Commissioner,* 338 F. 2d 815, and in *Northrup* v. *United States,* 240 F. 2d 304, and the Fourth Circuit in *Commissioner* v. *Estate of Antrim,* 395 F. 2d 430, have employed a different hypothetical dividend test for determining dividend equivalency, the district court correctly observed (Pet. App. 39-40) that these decisions can no longer be viewed as viable in the light of this Court's adoption of the strict net effect test in *Davis.*[6]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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Solicitor General.

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[6] Petitioners' reliance (Pet. 19) upon *Stanley F. Grabowski Trust* v. *Commissioner,* 58 T.C. 650, is also unfounded. Unlike this case, the Tax Court there, in upholding the Commissioner, observed that the taxpayer did not even meet the requirements of the hypothetical dividend test.

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